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ABSTRACT

In many colleges and universities the responsibility of the governing board's audit committee is to arrange and oversee regular audits of financial activities, comply with donor restrictions on gifts, adhere to laws and regulations, and conform to established board policies. Membership of three to five is usually sufficient, and while the institution's financial management will attend meetings, they do so as staff support to the committee, without vote. Familiarity with financial reporting, accounting practices, and key fiscal issues in higher education are important qualities, as are common sense and independent judgment. The committee selects independent accountants to perform the annual audit, meets with auditors before the process begins to review the scope of the audit and procedures, and to review the audit findings. reviews the auditors "management letter," presents the financial statement to the full board, reviews the results of other work done by the auditors (e.g., intercollegiate athletics and pension plan audits), determines the extent to which outside auditors will rely on internal auditors' work, and oversees the institution's conflict-of-interest policy. It should meet at least twice yearly. (MSE)

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BOARD BASICS

EFFECTIVE COMMITTEES

THE AUDIT COMMITTEE

BY JOHN S. OSTROM

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THE AUDIT COMMITTEE

For many reasons, college and universities have become subject to intensive scrutiny not only by the public, the press, governmental agencies, and financial institutions but also by alumni, donors, faculty, and students. These constituents are demanding greater access to more detailed information. Consequently, trustees and senior administrators need timely, reliable financial information to help them better understand the fiscal condition of the institution.

Among its many responsibilities, boards of trustees must ensure the institution does the following:

- arranges and oversees regular audits of financial activities,
- complies with donor restrictions on gifts,
- adheres to laws and regulations, and
- conforms with established board policies.

For many colleges and universities, these roles are the responsibility of the audit committee. Long established as part of a corporate board structure, the concept of an audit committee for nonprofit organizations is relatively new, and in some cases the committee's responsibilities may be subsumed by another board committee. Regardless of whether the audit committee exists or the board is establishing a new one, institutional bylaws should provide a clear definition of the audit committee's authority and responsibilities.

COMMITTEE CHARGE

The primary responsibility of the audit committee is to provide oversight of the institution's financial practices, internal controls, financial management, and standards of conduct. Specifically, it is responsible for (1) reviewing and understanding financial statements, (2) assuring the board that the statements reflect the institution's financial condition, (3) determining the adequacy of internal controls surrounding financial information systems, and (4) ensuring adherence to the institution's conflict-of-interest policy.

The extent to which the committee involves itself in the development of financial reporting will depend on its own level of expertise and its degree of comfort with that of the institution's financial staff. The audit committee is not intended to be a policy-making body. Its role is to help the full board carry out its fiduciary duties, not to replace the board in developing and approving financial policy.

COMMITTEE STRUCTURE

An audit committee does not need a large membership; three to five members usually is sufficient. While the institution's financial management will attend the meetings, they do so as staff support to the committee and should not have a vote. Helpful qualities for members of the committee include familiarity with financial reporting, accounting practices, and key fiscal issues in higher education. However, more important are common sense and independent judgment. Continuity of membership is highly important; staggered, multiyear terms are desirable. At the same time, it is helpful to have some turnover to provide for fresh perspectives.

A favorite old saw for accountants is "audit the business, not the books." Basically, this means that an auditor must thoroughly understand the nature of the business to comprehend the financial numbers. A similar caveat applies to members of the audit committee. Financial statements for colleges and universities are not the same as those for profit-making businesses. Revenue streams flow independent of expenses and vice versa. As a result, understanding the institution's financial position

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will require looking at such diverse information as applications and admissions data, results of fund-raising efforts, financial-aid policies, and so forth. Without a good understanding of the differences between for-profit and not-for-profit accounting, committee members will be at a serious disadvantage in fulfilling their responsibilities. Appropriate orientation for new members should be provided by the institution's financial staff with directions from the committee chair.

Historically, college and university financial reporting was the output of a fund-accounting system, often unfamiliar to and frequently misunderstood by trustees. The Financial Accounting Standards Board (FASB) has mandated substantive changes in reporting requirements that will result in more aggregated financial reporting for all nonprofits under their jurisdiction; these changes were to take effect in 1996. FASB expects external users of these statements to more readily understand them as a result of the changes.

Audit committees of independent colleges and universities will have a special responsibility to be sure that these statements provide adequate and full disclosure of the institution's financial condition.

At this time, the Government Accounting Standards Board (GASB) has chosen to stay with fund-accounting reporting standards. However, modifications are under discussion, and audit committees of public institutions will have to stay informed of developments.

THE COMMITTEE
SHOULD ACQUAINT
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AUDITOR'S APPROACH
TO EVALUATING THE
INTERNAL CONTROL
STRUCTURE TO PROVIDE
SUFFICIENT ASSURANCE
THAT THE AUDIT WILL
COVER ALL AREAS.

COMMITTEE RESPONSIBILITIES

While individual circumstances may create different scenarios, audit committees have certain basic responsibilities.

1. The committee selects independent accountants to perform the annual audit. Generally, this task involves reviewing the performance of the firm currently conducting the audit and determining the terms and conditions of the firm's continued appointment. At some point, circumstances may suggest the need for selection of a new firm.

Some institutions choose to change audit firms on a regular basis. This may be a matter of policy, or for some public institutions, it may be required by state law. Generally, however, staff within any single firm turns over at a sufficient rate to make changing firms unnecessary. Perhaps more important are the advantages to be gained in developing an ongoing relationship with a single

firm. Regardless, the audit committee should be prepared to recommend its selection for approval by the full board. Whether that recommendation includes specifying the fee for the audit depends on normal procedure of the board. (The National Association of College and University Business Officers has published a monograph, *Changing Auditors*, which can be helpful when contemplating a change.)

2. *The committee meets with the auditors before the process begins to review the general scope and procedures for the audit and to discuss areas where the committee may desire special emphasis.* While the auditors must comply with professional standards of independence, they are not averse to modifying their audit programs where the board has identified areas of specific concern, such as adequacy of collection efforts on student loans, competitive bidding practices for major purchases, compliance with government regulations for sponsored programs, and so forth. In large institutions, it is not uncommon for the auditors to review the operations of major divisions on a rotating basis. In such cases, the audit committee may want to work with the auditors in selecting which areas to cover in a particular year.

In addition, the committee should acquaint itself with the auditor's approach to evaluating the internal control structure to provide sufficient assurance that the audit will cover all areas. The American Institute of Certified Public Accountants has defined "internal control" as "a process—effected by an entity's board of directors, management, and other personnel—designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations."

Another area of concern for the committee will be to understand how the auditors will use information technology in performing the audit and whether their approach will include a review of computer security surrounding the critical administrative systems of the institution. Colleges and universities have become highly dependent on ever-changing software systems for administrative processes. The audit committee should seek assurance that these systems have adequate safeguards to protect them from outside interference and that they have been tested to ensure they perform as intended. The audit committee should determine the competence of the external auditors to perform this important review and the extent of their testing.

3. *Upon completion of the audit, the committee should again meet with the auditors to review the financial statements, their report on the adequacy of internal controls, and other findings.* Preferably, this meeting should be held prior to publication of the institution's annual report. The review of the financial statements should include the accompanying narrative, known as the management discussion and analysis (MDA). Although publicly held for-profit corporations must pay close attention to the MDA, nonprofits are finding accounting standard-setters increasingly are focusing on the narrative as well. (Colleges and universities are not required to include a narrative with their financial statements, but an increasing number of schools are doing so, particularly when the financial statements are part of an institution's annual report.)

After their examination, the auditors issue an opinion on the institution's financial statements. The audit committee must understand the nature of that opinion. The institution seeks an opinion with no exceptions—known as an "unqualified opinion"—which certifies the financial statements have been prepared in accordance with generally accepted accounting principles. A "qualified opinion," indicating failure to meet accepted accounting principles, is apt to be viewed negatively by lenders and contributors.

The auditor's opinion states that the financial statements "present fairly" the institution's financial position. In reviewing and commenting on the statements, the audit committee should be sensitive to the implications of this declaration, that the readers of the financial report will comprehend the strengths and weaknesses of the institution, and that both the notes to the statements and the accompanying narrative are written in a clear, meaningful fashion to facilitate understanding. While colleges and universities must follow "generally accepted accounting principles" (GAAP), there is still considerable room for discretion in the quality and quantity of disclosure.

The committee must ensure that the auditors do not take control of the financial statements. The statements are the responsibility of the institution's management, and the auditors are charged with rendering an opinion on their fairness. Senior administrators may work closely with the external accountants in preparing the statements, but they should not surrender control over the content. The audit committee needs to oversee the process of their preparation and support the institution's fiscal staff in their efforts.

4. The committee should review the auditor's "management letter."

Customarily, the auditors will issue a letter to the audit committee that identifies any internal control weaknesses it may have uncovered during the course of the audit. If the auditors have suggestions for improvements in controls, the institution's management should be prepared to identify corrective action it plans to take and the schedule for these changes. At a future meeting, the committee should determine whether the proposed changes have occurred and that the auditors agree that their recommendations have been implemented. Although the management letter ordinarily is addressed to the board, some audit committees prefer to have a single document that incorporates management's response with the auditor's comments, including proposed corrections.

At some institutions, the auditors also may issue a letter to management that recommends changes in procedures or points out minor problems it encountered during the course of the examination that did not warrant reporting directly to the audit committee or including in the management letter. Management is free to decide whether this letter needs to be shared with the audit committee for their information.

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5. Once the post-audit review is completed, the audit committee should be prepared to present the financial statement to the full board. Action by the board is not required since the audit committee has accepted the report from the auditors on the board's behalf. Depending on the board's expertise, it may be appropriate for either the committee chair or an appropriate officer of the institution to provide highlights of the financial report. While the institution may provide the board with other important financial information, the official financial statement is what most outsiders—including lenders, donors, and others—will see.

6. The committee also should review the results of other work done by the auditors. In addition to the audit of the financial statements, other audit work may be required—for example, the annual audit of intercollegiate athletics required by the National Collegiate Athletic Association (NCAA), audits of pension plans and other employee-benefit programs required under the Employee Retirement Income Security Act (ERISA), and audits of research and other government-supported programs for compliance with federal regulations, known as the A-133 audit. While any auditor can conduct these reviews, it normally is more cost-effective to have them done by the same firm that audited the general-purpose financial statements.

One peripheral task for the committee is to review the extent to which the external audit firm also is engaged in providing consulting services. It is not unusual to find that consulting fees exceed the cost of the audit. The role of the audit committee is to ensure that this does not jeopardize the independence of the auditors. There is no reason that such consulting needs to be done by the firm conducting the audit. Although some may argue that the audit firm has greater familiarity with the institution's management practices, this consulting work generally will be done by different staff than those on the audit team. Additionally, there may be an advantage in gaining a fresh perspective by employing a different firm, depending on the nature of the work required.

A KEY RESPONSIBILITY

OF THE INTERNAL

AUDIT FUNCTION IS

DETERMINING THE

EFFECTIVENESS OF

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FOR REVIEW.

7. *If the institution has an internal audit staff, the committee should determine the extent to which the outside auditors will rely on their work.* Regardless of whether such a staff exists, the audit committee should be sure external auditors and the institution's financial staff work together to complete the audit in a timely and economical fashion.

Internal audit can be an important part of the fiscal management of the institution. An issue of some debate is where the function fits within the organization—that is, what should be the reporting relationship of the internal-audit function. Strict constructionists recommend that the position report directly to the board of trustees and operationally to the president. Others argue the chief financial officer should be able to use internal audit as a management and investigative tool. Still others suggest that since auditors are supposed to check the functions reporting to the chief financial officer, the audit function should be independent of that office.

Regardless, internal auditors should have the support of the institution's management and its board, and in particular, there should always be an unrestricted direct line of communication between the internal auditor and the audit committee of the board.

As is the case with external auditors, the committee needs to discuss with internal auditors their audit activities, scope, and procedures, as well as their findings and recommendations. A key responsibility of the internal audit function is determining the effectiveness of internal controls, since their year-round presence provides an ongoing opportunity for review.

In meeting with the internal auditor, the committee should be apprised of any fiscal irregularities that may have occurred in the previous year and should find out what actions the institution's management needs to take to prevent a recurrence. The committee can accomplish this either by asking for copies or summaries of all internal audit reports.

8. *The committee should provide oversight of the institution's conflict-of-interest policy, including how it pertains to the board.* The committee should ensure that senior members of the administration and all members of the board have provided adequate disclosure of outside interests and relationships that might bear, in any way, on their responsibilities to the college. The committee may play a significant role in the development of the policy, including defining what constitutes an inappropriate transaction or activity. In some organizations, the audit committee also is asked to oversee a review of executive travel expenses to be sure institutional policies have been followed.

COMMITTEE AGENDA

The audit committee should plan to meet at least twice each year, before and after the work of the external auditors. When meeting at other times in conjunction with regular board meetings, the committee may find it convenient to become familiar with higher education financial and accounting issues. Committee members should understand and be capable of reporting on the institution's activities by becoming aware of the following:

- emerging technical issues;
- legal environment, including the status of pending lawsuits;
- compliance with contract terms and regulations for programs funded by governments and private sources;
- impact of tax laws and regulations; and
- status of federal audits of sponsored programs or Internal Revenue Service reviews of nonprofit status.

During the course of its meetings, the committee should take time to meet privately and confidentially with the external and internal auditors and the institution's chief financial officer. This provides time to discuss issues and concerns that may be inappropriate for open sessions. At the same time, such meetings permit members of the audit committee to ask the external auditors if they need to be aware of any potential problems and to evaluate the competence of the institution's fiscal staff. For public institutions, state sunshine laws limit the ability to hold closed meetings.

CONCLUSION

The audit committee has the opportunity to play a critical role in exercising the trustees' fiduciary responsibilities. While not intended to establish policy, the committee can influence the degree to which the college or university provides meaningful financial information to donors, lenders, government officials, and all other interested parties. At the same time, it also can ensure that the board of trustees is kept adequately informed. The committee may be small in number, but its importance in fulfilling the oversight role of the board is great.

RESOURCES

Coopers & Lybrand, L.L.P. *Audit Committee Guide*. New York: Coopers & Lybrand, L.L.P., 1995.

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BOARD BASICS

This publication is part of an AGB series devoted to strengthening the role of key standing committees of governing boards. Several assumptions underpin the series:

- The work of boards should be accomplished in committee. An effective committee system will enhance the productivity of full board meetings.
- The committee structure of any board should mirror the full range of its responsibilities as a legal, corporate entity. That is, the committee organization should cover the oversight roles expected of trustees.
- Although there is no optimum committee system, certain principles and procedures should prevail: The board's bylaws or other operating policy should include a clear, comprehensive statement of responsibility for each standing committee. Each committee should be staffed by an appropriate administrative officer; a trustee or regent should serve as chair. No trustee should serve on more than two active committees, preferably one—excluding the executive committee.
- Before scheduled meetings, each committee member should receive a concise, well-conceived meeting agenda and relevant background information prepared by the committee chair and staff. Committees are responsible for recommending decisions and actions to the full board.
- As committee members seek additional information to fulfill their responsibilities, it is important to strike a balance between "too much" and "too little." Committee members must guard against requesting overly detailed information to avoid the appearance of becoming embroiled in administration or overburdening it. Before members make information requests, perhaps they would be well-served by asking if all such requests contribute to the committee's and the board's responsibilities for reviewing, setting, or approving institutional policies.

The *Effective Committees* set of booklets comprises publications on the following committees: investment, buildings and grounds, academic affairs, student affairs, finance, development, trustees, audit, and executive. It is part of the **AGB Board Basics Series**. AGB and the authors welcome comments and suggestions to improve this publication and the others in the series.



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